# IRS Kicks Off Post-*Altera* Audit Adjustments

September 21, 2020

Taxpayers with cost sharing arrangements ("CSAs") can again expect close audit scrutiny—and potential adjustments—related to their treatment of stock-based compensation ("SBC") costs. On June 22, the Supreme Court denied certiorari in *Altera*, letting stand the decision of the U.S. Court of Appeals for the Ninth Circuit upholding the validity of the IRS regulation requiring the sharing of SBC costs under a CSA. The IRS had suspended audit adjustments based on the regulation while the case was pending, but since the Supreme Court declined review, it has announced its intent to audit and adjust taxpayers with *Altera* issues, i.e., those that have not been sharing SBC costs under their CSAs, in all Circuits, not just the Ninth.

IRS LB&I Commissioner Doug O'Donnell has cast *Altera* as an important win for the IRS that can be used as leverage at IRS Appeals and in any future litigation outside the Ninth Circuit, and as an encouragement to develop strong transfer pricing issues on audit—putting CSA taxpayers on notice. This Alert describes the menu of options available to a CSA taxpayer with an *Altera* issue and outlines key technical, procedural, and state tax considerations that a taxpayer should take into account in developing and implementing a strategy.

**Exploring the Options**

For CSA taxpayers with *Altera* issues, the Supreme Court's decision presents questions for filed and future years. For filed years, three options are now on the table: proactively prepare for audit, take the hit and amend open years and/or volunteer adjustments, or wait and see.

Preparing and mounting a robust audit defense is likely a meaningful option only for taxpayers outside the Ninth Circuit, where *Altera* is generally the law of the land. In other Circuits, the full panoply of technical arguments raised in the *Altera* litigation, discussed further below, remain viable. In addition to honing the substantive support for their positions, taxpayers should marshal the facts, preserving critical data on SBC costs and intangible development costs ("IDCs") for relevant years in anticipation of IDRs. Audit preparation should take into account not only the likelihood of an IRS audit but also the possibility that certain states may view the *Altera* decision as authorizing them to make transfer pricing adjustments at will.

Taxpayers lacking an appetite for controversy may consider acting unilaterally to resolve their *Altera* issues by amending filed returns for years open to adjustment and/or volunteering affirmative adjustments during the audit cycle—again, at both the Federal and state levels. A taxpayer has no duty to amend a return position taken in good faith, but especially for Ninth Circuit taxpayers, volunteering adjustments and any additional tax may mitigate the overall exposure. State Departments of Revenue ("Departments") have long supported voluntary resolution through disclosure programs whereby a taxpayer can negotiate a favorable settlement of past liabilities with the added benefits of limited lookback periods and waivers of penalties. Certain states like North Carolina have already announced voluntary corporate transfer pricing resolution initiatives in the wake of *Altera*.

Terms in the CSA providing for specific actions in the event of an IRS win in *Altera* may heavily influence whether to implement adjustments unilaterally, and if so, how. For Federal income tax purposes, taxpayers are generally "bound by their form" and thus expected to comply with the terms of their contracts. As discussed further below, compliance with form may entail making a current-year adjustment to the IDC allocation to account for SBCs not shared in specified earlier years. Although the adjustment may flow through current-year financials and cash, we question whether the IRS would require tax adjustments to the earlier years—especially years for which the corporate income tax rate was 14 points higher than it is today.

Some taxpayers will prefer a wait-and-see approach. As noted above, a taxpayer has no legal duty to amend its returns or volunteer adjustments, and some CSA taxpayers may avoid the audit dragnet. For taxpayers with material unshared SBC costs in open years, however, a proactive approach seems the wiser course.

**Lining Up Technical Arguments**

The *Altera* pleadings and decisions provide a roadmap of the key technical arguments for CSA taxpayers preparing to defend their treatment of SBC on audit.

At bottom, *Altera* turned on deference to an agency's statutory interpretation. Treasury Regulations section 1.482-7A(d)(2) requires the inclusion of SBC in the costs shared pursuant to a CSA.[1] Altera Corporation argued that, for multiple substantive and procedural reasons, this regulation exceeds Treasury and IRS' authority to interpret section 482. In evaluating that claim, both the Tax Court and the Ninth Circuit applied the standards of deference to agency decision-making prescribed by the Supreme Court's *Chevron* and *State Farm* decisions,[2] ultimately reaching conflicting conclusions. The Supreme Court denied certiorari in *Altera* without comment, thus taking no position on the two lower courts' different applications of regulatory deference—but in other contexts, the Supreme Court has expressed increasing skepticism of *Chevron* and appears poised to further limit or even abandon it. Courts outside the Ninth Circuit may thus be more receptive to the arguments made by the taxpayer in *Altera*, and taxpayers gearing up for audit should closely follow administrative law developments in their Circuits.

Altera Corporation challenged the SBC regulation on both substantive and procedural grounds. Substantively, the taxpayer argued the regulation was invalid because it was issued without evidence that unrelated parties engaged in comparable arrangements would share SBC costs—and, indeed, in the face of evidence indicating that they would not do so. Treasury and IRS insisted that no reliable and genuinely comparable evidence from arm's length arrangements was available, and that in such cases, the commensurate with income ("CWI") standard added to section 482 by Congress in 1986 authorizes rule-making on the basis of economic hypotheses about how arm's length parties would operate in comparable conditions. Yet, as the taxpayer pointed out, Treasury had historically interpreted CWI as fully consistent with the arm's length standard—that is, as limiting the IRS' transfer pricing adjustment authority to achieving tax parity between related parties and comparable unrelated parties in the marketplace. The full Tax Court and at least three Ninth Circuit judges agreed CWI could not justify the regulation, so in effect, the Ninth Circuit panel decision reflects a minority view of all the judges that have considered the issue. Courts in other Circuits may not accord it much weight.

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[1] The regulation applies for stock-based compensation granted in taxable years beginning on or after August 26, 2003, and for CSAs in existence on or before January 4, 2009. A new, but substantially equivalent, regulation applies to later periods.
[2] *Chevron U.S.A., Inc. v. National Resources Defense Council, Inc.*, 467 U.S. 837 (1984); *Motor Vehicle Manufacturers Ass'n of the United States, Inc. v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983).

The taxpayer in *Altera* also cited multiple procedural errors in the notice-and-comment rulemaking process, including Treasury and IRS' failure to adequately address comments and to explain the legislative basis and rationale for the rule. While the Ninth Circuit largely dismissed these perceived foot-faults, procedural irregularities could invalidate the rule under administrative law principles even in the absence of any substantive flaws.

Along with these substantive and procedural arguments, all of which remain available to taxpayers outside the Ninth Circuit, Altera Corporation raised powerful policy claims: in its broad network of bilateral income tax treaties, the United States has agreed to an arm's length standard predicated on evidence of market behavior, and Treasury's position in the litigation conflicted with those treaty obligations. In our view, this policy argument has considerable force. Carried to its logical conclusion, Treasury and IRS' stance could embolden foreign tax authorities to impose transfer pricing adjustments on U.S. companies on the basis of idiosyncratic interpretations of the arm's length standard. In a bilateral context, reliance on evidence from comparable uncontrolled transactions provides an objective, empirical basis for resolving disputes. Untethered from such market evidence, "arm's length" is in the eye of the beholder, and rampant double taxation could result. Courts may well reason that Congress did not intend such an outcome.

**Evaluating Procedural Issues**

For companies that prefer to prepare for a potential IRS examination of this issue, certain steps should be taken now. Engaging counsel that was not involved in the original tax return reporting position, to coordinate the examination strategy, may help to protect attorney-client privilege.[3] Under certain facts, recent court cases have allowed the IRS to access confidential communications between clients and their counsel, accountants, and economists who were involved in the planning and tax return preparation.[4]

Furthermore, understanding the jurisdictional rules of available litigation forums will enable companies to understand what law will apply (*i.e.,* Ninth Circuit or another) in the examination. The litigation forums available to taxpayers are the U.S. Tax Court, the U.S. Court of Federal Claims, and the various U.S. district courts across the country. The litigation forums each have different jurisdictional rules that potentially have an impact on the substantive law that is applied. The U.S. Tax Court applies the *Golsen* rule for purposes of applying the substantive law.[5] Under this rule, a corporate taxpayer with a principal place of business or principal office or agency outside of the Ninth Circuit can argue that the Tax Court is not bound by the Ninth Circuit decision.[6] U.S. district courts outside of the Ninth Circuit are not bound by the Ninth Circuit's ruling in *Altera*. Taxpayers, including taxpayers within the jurisdiction of the Ninth Circuit, also have the U.S. Court of Federal Claims, which is not bound by Ninth Circuit precedent, as another trial court option.

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[3] *Cf. In re G-I Holdings Inc.*, 218 F.R.D. 428, 434, 437 (D.N.J. 2003).

[4] *See AD Investment 2000 Fund LLC v. Comm'r*, 142 T.C. 248, 257-58 (2014); *compare New Phoenix Sunrise Corp. v. Comm'r*, 408 F. App'x 908, 918-20 (6th Cir. 2010), *with United States v. Sanmina Corp.*, 968 F.3d 1107, 1118-19, 1125-26 (9th Cir. 2020).

[5] *See Golsen v. Comm'r*, 54 T.C. 742, 756-57 (1970), *aff'd*, 445 F.2d 985, 988-89 (10th Cir. 1971).

[6] *See* 26 U.S.C. § 7482(b)(1)(B); T.C. R. 190(c) (venue for appeals from the Tax Court).

**SALT Ramifications**

Related party transactions have long been an area of focus for state revenue agencies. The ways in which states have addressed problematic intercompany transactions have included forced combination, economic nexus, expense disallowance ("addback") provisions, or broad application of Section 482 or 482-like powers. No matter the preferred state framework for arriving at a taxpayer's income tax liability, related party transactions routinely lead to complex and difficult audits and correspondingly significant proposed deficiencies.

Given the substantial history with transfer pricing and related party transactions, the *Altera* decision is not likely to go past states unawares. Taxpayers should expect that revenue agencies within the Ninth Circuit, as well as separate company states outside the Ninth, may rely upon the *Altera* decision as authority for proposed adjustments that fall outside the historical principles of Section 482 or the state's own 482-like authority.

In anticipation of a forthcoming increase in state audit activity, taxpayers with CSAs should be prepared with good documentation to establish the validity of the arm's length rates, as well as the knowledge of how pertinent states apply transfer pricing in light of *Altera*. Just as important will be understanding the ability to negotiate favorable state resolutions prior to an audit, such as with disclosure programs.

**Revisiting CSA Language**

Some taxpayers addressed uncertainty surrounding the treatment of SBC by adding two-pronged provisions to their CSAs. The first prong would require the U.S. participant to return SBC paid by a foreign participant in the event of a final taxpayer-favorable *Altera* court determination (a "clawback" provision), or to credit it against IDCs otherwise due from the foreign participant. For periods in which SBC was not included in IDCs, the second prong would require foreign participants to make one-time payments to the U.S. participant for back-year amounts following a final unfavorable *Altera* decision (a "reverse clawback").

While clawback provisions have now been largely mooted (for Ninth Circuit taxpayers), reverse clawback provisions present taxpayers with a choice. Including SBC adjustments in the current year could be favorable. Inclusions will be taxed at 21% (or potentially a lower rate, if the U.S. participant earns foreign-derived intangible income ("FDII"), rather than at 35%, and the foreign deduction could reduce any GILTI inclusion. However, the IRS may not accept reverse clawback provisions. The IRS could view such provisions as undermining the annual accounting concept, with potentially broader implications. Taxpayers could be encouraged to address other tax risks contractually, such as by agreeing to later-year inter-company pricing adjustments if any IRS adjustment is sustained, in effect creating tax "options" that offer the better of current and undefined future tax outcomes. We expect courts could share these concerns.

Taxpayers may, therefore, opt to ignore reverse clawback provisions and amend past-year returns. Failure to do so could increase the chances that the IRS will apply transfer pricing or other penalties for those years. Also, a taxpayer may be whipsawed by its own planning if the IRS adjusts past-year returns, and the taxpayer is precluded from backing out a reverse clawback payment because Treasury Regulations section 1.482-1(a)(3) prohibits certain downward U.S. transfer pricing adjustments.

**Taking Action Now**

If nothing else, CSA taxpayers should—in the current tax year—conduct a risk assessment. If a company has an *Altera* issue, it should aim to quantify the amounts of income and tax at stake for open years, including taking into account the possibility of a six-year statute of limitations for years in which SBCs were omitted from IDCs. Based on that evaluation, the company should develop and implement a strategy that makes sense for its tax and contractual profile, consulting with counsel as needed on the transfer pricing, procedural, and SALT considerations.

For more information regarding the implications of *Altera* and how they may affect your business, please contact:


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